Outlook and Policy in 2020

GROWTH WEAKENED BY THE COVID-19 PANDEMIC

Markedly weaker global growth prospects

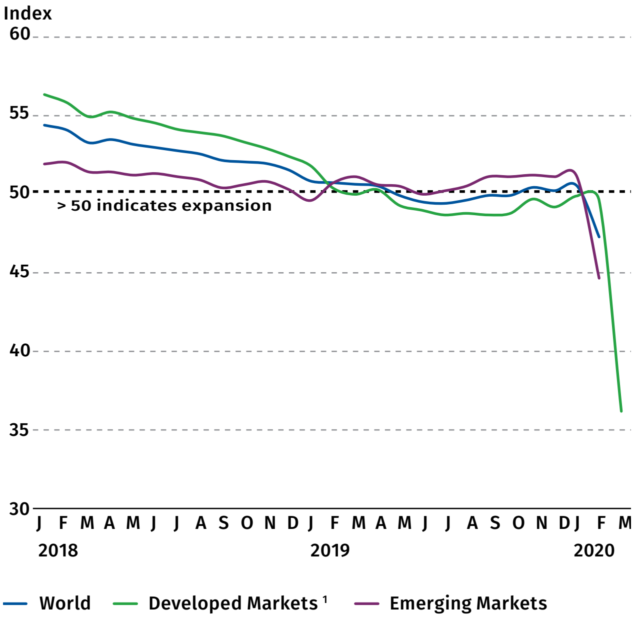
The global economy is projected to register a negative growth in 2020. The ongoing COVID-19 pandemic has significantly weakened global growth prospects, with the outlook heavily contingent on how countries across the world successfully contain the pandemic over the remainder of the year. The IMF[1] is expecting a recession in 2020 that is at least as bad as during the global financial crisis in 2009, and is projecting a recovery in 2021.

The COVID-19 pandemic has evolved into a global health crisis that is causing a sharp growth slowdown in the affected countries, including most major advanced and emerging market economies. The measures taken to contain the spread of COVID-19, including travel restrictions, enforced business closures and restricted social activities, while critical, are suppressing private sector activity, both in the domestic-oriented and tourism-related sectors, as well as in the manufacturing sector. The pandemic is simultaneously causing demand and supply shocks through weaker final demand and supply-chain disruptions. Prospects for global growth will depend on how fast the pandemic is contained and stopped.

Latest indicators suggest that global growth in the first half of the year will be significantly weak. The Purchasing Managers' Indices (PMIs) for manufacturing and exports, which were showing incipient signs of recovery towards end-2019, declined sharply in the first three months of 2020 (Chart 2.1 and Chart 2.2). The impact from PR China's extended production shutdown and quarantine between late January and March is evident in the marked decline in the PMI for emerging markets. As advanced economies affected by COVID-19 adopt similar containment measures in March, a similar trajectory is also observed.

The spread of COVID-19 to the advanced economies is projected to result in a growth contraction in these economies. In the US, GDP growth is forecasted to contract. Household expenditure would be affected by lower income from subdued labour conditions, while corporate investment would be dampened by moderating profits and poor sentiments. Similarly, growth in the euro area is likely to contract as the increasing number of COVID-19 cases has prompted more restrictive quarantine measures. These developments have exacerbated the already weak outlook from the lacklustre automobile manufacturing sector, particularly as spending on non-essential goods diminishes.

Chart 2.1: Manufacturing Purchasing Managers' Index (PMI)

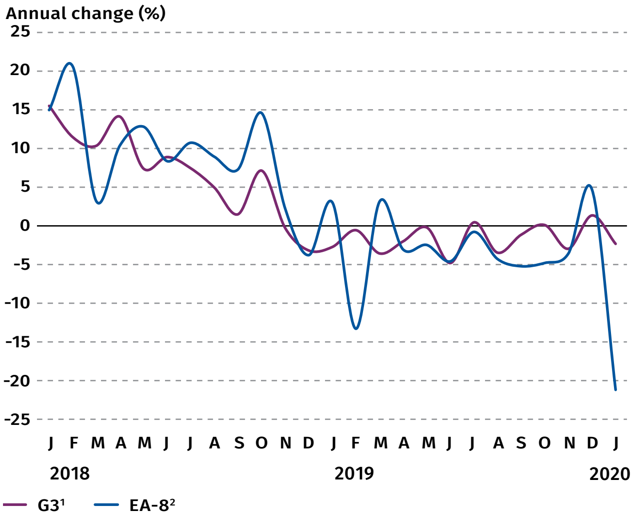


[1] Including average of Flash Composite PMIs for March 2020

Source: IHS Markit

[1] IMF Managing Director, Kristalina Georgieva's statement following a G20 Ministerial Call on the COVID-19 Emergency on 23 March 2020.

Chart 2.2 : Exports Growth (USD terms)



[1] G3 refers to the US, euro area and Japan
[2] EA-8 refers to PR China, Hong Kong SAR, Indonesia, Malaysia, South Korea, Singapore, Chinese Taipei and Thailand. The value of PR China's most recent export growth is the average of the combined release for January and February

Source: Bloomberg and Bank Negara Malaysia

Growth prospects for the regional economies, including PR China, are forecasted to be weak. Quarantine measures are expected to lead to poor consumption and investment activities, and may result in negative growth in some countries. In line with the projected contraction in the advanced economies, subdued external demand conditions and disruptions in the global supply chain will further weigh on growth in the trade-dependent Asian region.

There is a possibility that the evolution of the COVID-19 pandemic globally would peak by the first half of 2020. The first epidemic in PR China started in January and has since tapered, with zero domestic cases by March. Elsewhere, COVID-19 entered a subsequent phase, with outbreaks observed in more than 100 countries, across Asia, the Middle East, the euro area, North America and most emerging economies.

The economic impact of COVID-19 is, however, expected to be partly mitigated by the significant monetary and fiscal stimulus measures introduced by authorities across the world. Globally, fiscal spending has been promptly increased, with funds primarily channelled towards containing COVID-19, supporting affected households against income and employment losses and providing liquidity support for firms. Among the key measures that have been introduced are direct cash assistance, job retention programmes, tax relief and public guarantees to facilitate access to financing. These measures are complemented by monetary policy responses to provide further liquidity support for households, businesses and the banking sector, as well as to ensure continued smooth provision of credit to the real economy. The unprecedented nature and scale of policy intervention across economies is expected to cushion the economic disruptions caused by COVID-19 and support a gradual recovery in real economic activity upon the successful containment of the pandemic.

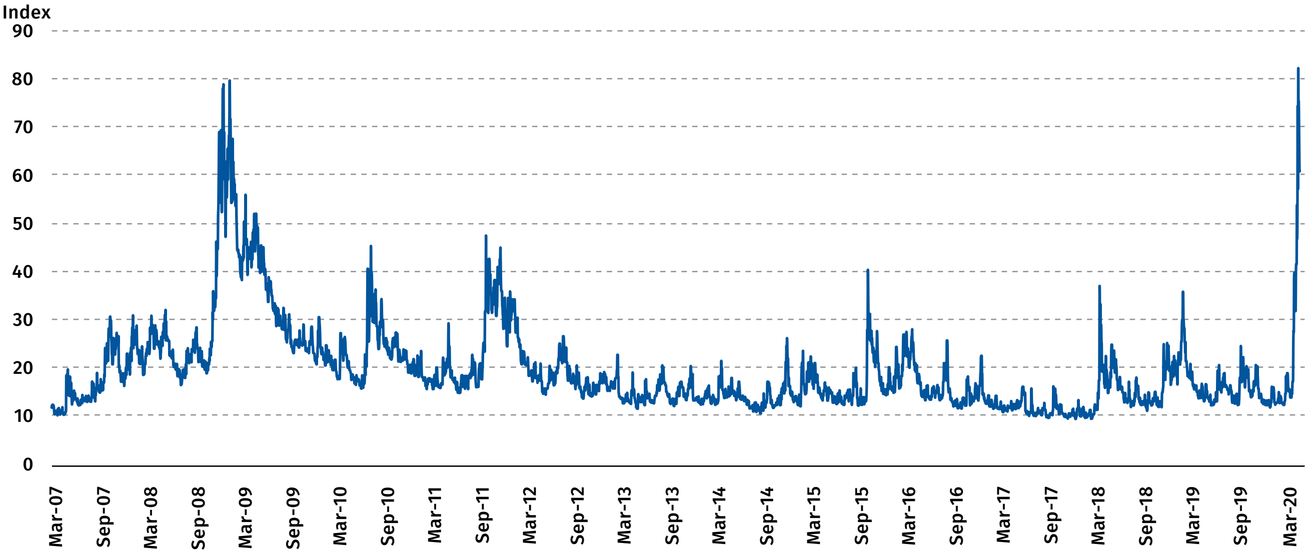
Balance of risks are tilted to the downside

Risks to global growth are tilted to the downside, mainly from uncertainties arising from the COVID-19 pandemic. The economic impact of this outbreak remains uncertain at this juncture and is highly contingent on how prolonged and severe the health crisis will be, as well as the consequent measures that governments undertake to contain the pandemic. This includes the extent of economic policy support to mitigate the economic impact of the outbreak.

Global financial conditions have tightened in recent months, corresponding with a sharp rise in volatility, sell-offs in major equity markets, and a depreciation in many currencies (Chart 2.3). This has been attributable to a confluence of factors, most pertinently from COVID-19 developments and the uncertainties in the global crude oil market. If such conditions intensify further or remain prolonged, the tightening of financial conditions, especially in emerging market economies could cause adverse spillovers that exacerbate the current weakness in the real economy.

The operating environment also remains susceptible to risks that have been present since last year. Key among these is the lingering trade dispute. While trade tensions between US and PR China have eased in recent months, a re-escalation of trade tensions as well as geopolitical conflict in the Middle East remain key downside risks to the global economy.

Chart 2.3 : Chicago Board Options Exchange (CBOE) Volatility Index (VIX)

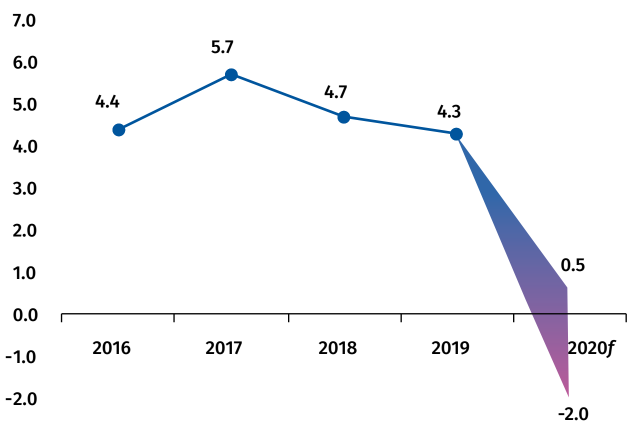


Source: Bloomberg

Malaysia's GDP projected to be between -2.0% and 0.5% in 2020

Global economic and financial conditions, which deteriorated sharply in the first quarter as the COVID-19 pandemic escalated, are expected to deteriorate further, with significant impact on the Malaysian economy. The domestic economy is also facing the economic effects from the necessary actions taken to contain COVID-19 locally and continued supply disruptions in the commodities sector. These shocks, particularly the significant economic repercussions induced by the unprecedented COVID-19 health crisis, are expected to weigh significantly on growth prospects for the year. The containment measures undertaken by authorities globally and domestically, which are critical and necessary, are projected to weigh on growth in the first half of the year. When the health crisis is eventually addressed, growth will be supported by the gradual improvement in household spending, further progress in the implementation of transport-related projects and higher public sector expenditure. The monetary policy responses and economic stimulus measures undertaken in the first half of the year will provide additional support to growth. The economy is subsequently expected to normalise in 2021, in line with the projected recovery in the global economy.

Chart 2.4: Malaysia's GDP Growth



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Source: Department of Statistics, Malaysia, Bank Negara Malaysia estimates

The COVID-19 pandemic and the measures taken to contain it are causing simultaneous supply and demand shocks to the domestic economy. The pandemic is adversely impacting tourism-related and manufacturing sectors. Broad-based restrictions and aversion to travel activities will have a sizeable impact on Malaysia's tourism sector, which accounts for 11.8% of Malaysia's GDP. Airport passenger traffic declined by 8.2%[2] in the first two months of 2020, just

[2] Compared to the same period last year. This includes both international and domestic passengers. Source: Malaysian Airport Holdings Berhad (MAHB).

as COVID-19 started to escalate and some economies began to take precautionary measures, such as travel bans and quarantines. These measures have since become more widespread and a sharp decline in tourist arrivals is expected. This will significantly impact spending in the tourism-related sectors, particularly hotels, retail trade, food and beverage and transport services.

In the manufacturing sector, prolonged factory closures in key industrial hubs in the COVID-19 affected countries is disrupting production activity across the global supply chain. As countries implement containment measures, firms are only able to operate at limited capacity amid labour and logistics constraints, resulting in domestic firms facing difficulty in procuring inputs[3] from source countries. The production disruptions abroad would also lower demand for Malaysian manufactured products, which are often used as input in the affected economies' exports to the rest of the world. Overall, this would compound the effects of weaker final demand from affected countries, thus weighing further on Malaysia's manufacturing activity and exports performance.

The rise in COVID-19 cases domestically since early March 2020 has necessitated implementation of measures to contain the spread. Accordingly, a two-week Movement Control Order (MCO) was implemented on 18 March 2020 and subsequently extended by another fortnight. Despite the continued provision of and access to essential services during this period, economic activity would nevertheless be impacted as non-essential services cease to operate and selected manufacturing firms operate only at partial capacity. Post-MCO, the reduced social and recreational activities are expected to continue until the pandemic is fully controlled globally and domestically, thus dampening consumption and investment activity.

The rapid spread of COVID-19 in the first three months of 2020 underscores the challenges of forecasting with precision the economic impact during this period. Globally, new COVID-19 cases have increased 22-fold in less than a month[4]. Its rapid transmission has prompted governments globally to implement unprecedented actions to stem the spread in their respective economies. Given Malaysia's high integration with the global economy, forecasting efforts are further complicated by the diversity in the nature, scope and intensity of the policy actions, as well as the severity of the outbreak in other economies.

Apart from the health crisis, the Malaysian economy is expected to be affected by the sharp decline and volatile shifts in crude oil prices. While this is partially a consequence of significantly softer global demand, crude oil prices are also weighed by the OPEC+ decision of not pursuing additional voluntary output adjustments. Prolonged low global oil prices will impact the income, employment and investment prospects in the mining-related sectors directly. Nonetheless, lower oil prices may alleviate cost pressures on consumers and businesses. Prices of other major commodities are projected to be lower. The price of Liquefied Natural Gas (LNG) is forecasted to moderate, weighed mainly by slower demand from Japan and PR China following further progress in the restart of nuclear plants[5] and production disruptions due to COVID-19, respectively. The price of crude palm oil (CPO) is projected to be relatively sustained, as weaker external demand is offset by the decline in CPO production.

The continued supply disruption in the commodities sector will continue to weigh on domestic growth. The low oil palm production[6] since end-2019 is expected to extend to the early months of 2020, due mainly to the lagged impact of severe dry weather conditions experienced in 2019 as well as output constraints arising from the MCO. These disruptions are, however, anticipated to dissipate gradually as weather conditions normalise and oil palm production benefit from higher fertiliser application in early-2020. Meanwhile, crude oil and natural gas production will be affected by continued maintenance works and to a certain extent, reduced operating capacity due to the MCO. The operationalisation of new fields in Sarawak and the commencement of the PETRONAS Floating LNG Dua (PFLNG2) facility in Sabah will partially offset the decline in output of the mining sector.

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[3] Intermediate inputs from PR China amounted to 21.9% of Malaysia's total imported intermediate goods. Further disruptions in advanced economies such as the US and EU will affect an additional 22.1% of Malaysia's imported intermediate inputs.

[4] Daily new cases globally increased from 1,981 on 1 March 2020 to 43,733 on 24 March 2020. Source: www.worldometers.info/coronavirus/coronavirus-cases/#daily-cases.

[5] Japan and PR China are major importers of Malaysia's LNG, accounting for 39.2% and 24% of LNG exports in 2019, respectively.

[6] Accounting for 38.6% of agriculture production in 2019.

In response, large countercyclical policy measures have been introduced by the Government and Bank Negara Malaysia to mitigate the economic impact of the COVID-19 pandemic. On 27 February 2020, the Government announced the first economic stimulus package, amounting to RM20 billion with funds to ease cashflow constraints for businesses, provide financial assistance and training for affected individuals and spur investment. The stimulus package was complemented by two consecutive reductions in the Overnight Policy Rate by a total of 50 basis points and measures to provide additional liquidity in the banking system. These were also supplemented by additional measures to increase household disposable income, which include flexibility for monthly cash withdrawal from the Employees' Provident Fund (EPF) for a year and the deferment in repayment of education loans[7]. The additional measures form part of the second economic stimulus package that was announced on 27 March 2020. This stimulus package, totalling RM230 billion, includes a moratorium on loan payments and loan guarantees. Overall, the second stimulus package aims to provide further relief mainly by increasing broad-based financial assistance for households, supporting employment retention and accelerating public sector spending on infrastructure upgrades. These measures are complemented with measures to temporarily defer loan repayments and facilitate the restructuring of loan and credit facilities, particularly for individuals and small and medium enterprises (SMEs)[8]. Cumulatively, these policy measures will provide a buffer and avert a sharper contraction in economic activities for the year.

These policy measures will mitigate the severe impact of COVID-19 on income and provide crucial support to household spending. Private consumption is expected to be weighed by weak labour market conditions, mobility restrictions and subdued sentiments in the first half of the year. During this challenging period, cash assistance to vulnerable households amounting to more than RM10 billion[9] and the flexibility to withdraw from EPF savings will increase household disposable income by an additional RM40 billion. On a broader scale, other measures were also introduced to reduce cost of living, sustain employment and improve cash flow for households. These measures include subsidies for utilities and wage subsidies, in addition to the deferment of loan repayments. Importantly, the broad-based policy support would cushion the impact of COVID-19 on household spending and enable a gradual recovery as labour market conditions eventually stabilise following the projected gradual improvement in global and domestic economic activities.

An increase in public sector expenditure will further support growth. The continuation of large-scale transport-related projects, such as MRT2, LRT3 and Pan Borneo highway and the implementation of upstream oil and gas, telecommunication and power generation projects by public corporations underpin the improvement in investment by the public sector. Higher spending by the Federal Government on the economic stimulus packages will lend further impetus to growth. These include the implementation of more small-scale projects worth RM4 billion, higher special allowances for medical personnel, the hiring of temporary contract nurses and increased allocation for the Ministry of Health.

On the external front, net exports of goods and services is expected to contract due mainly to a larger decline in exports. Gross merchandise exports are projected to register a larger negative growth, reflecting primarily weaker global demand conditions following the spread of COVID-19 across many major economies. Commodities exports are expected to contract further due mainly to lower prices of crude oil and LNG, as well as weaker commodities production.

Gross imports performance is projected to register a larger contraction, mainly reflecting weaker external and domestic demand. Intermediate imports are projected to decline, mainly in line with the weakness in manufactured exports. Capital imports will register a smaller contraction as slower domestic investment activity will be partially offset by the delivery of the PFLNG2 in the first half of the year. Consumption imports are also likely to decline amid slower domestic demand conditions. Consequently, the current account surplus is projected to narrow to 1.0 - 2.0% of GDP in 2020 (2019: 3.3% of GDP).

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7 Additional measures were announced by the Prime Minister on 16 March 2020 and 23 March 2020.
8 For more details, please refer to the BNM press release dated 27 February 2020 on 'Measures to Assist Businesses and Households Affected by the COVID-19 Outbreak'.
9 Refers to *Bantuan Prihatin Nasional* and *Bantuan Sara Hidup*.

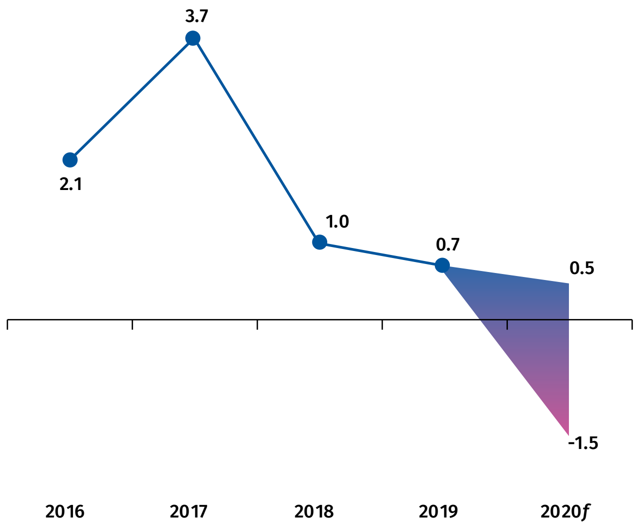
Nonetheless, the Malaysian economy is expected to benefit from the projected improvement in global demand towards the end of the year, which will aid to lift growth in the export-oriented sectors. As risks from the pandemic subside, consumer sentiments can also be expected to gradually improve when travel retrictions are eased and tourism activities resume. In addition, production in the mining and agriculture sectors are projected to improve in the second half of the year amid the expected recovery from the supply disruptions. Malaysia's domestic growth prospects is therefore projected to improve towards the end of the year and subsequently in 2021.

Given the constantly evolving risks in the external and domestic environment, however, overall risks to the growth projection is tilted downside. The baseline growth forecast could be lifted by a stronger-than-expected impact from the various stimulus measures and the additional measures implemented by several state governments. Meanwhile, the main downside risk is a prolonged and wider spread of COVID-19 and its effects on the global and domestic economy. The baseline growth projection is therefore, highly contingent on the effectiveness of efforts to contain COVID-19. Growth also remains susceptible to a recurrence of commodity supply shocks, which may adversely affect the production of oil palm, natural gas and crude oil. Low commodity prices pose additional risks to production in the commodities sector, exports and income growth. Meanwhile, periods of heightened financial market volatility due to ongoing external uncertainties may lead to tighter domestic financial conditions.

Subdued inflationary pressure in 2020

Headline inflation is forecasted to average within the range of -1.5 to 0.5% (2019: 0.7%) (Chart 2.5). The downward pressure on inflation predominantly reflects the expectation of significantly lower global oil and commodity prices. The trajectory of headline inflation is contingent upon the developments surrounding global commodity prices, particularly global oil prices, which remain highly uncertain.

Chart 2.5: Malaysia's Headline Inflation, Annual Change (%)



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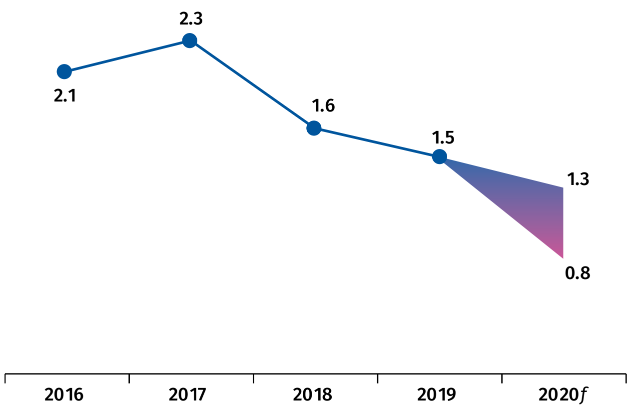
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 2.6: Malaysia's Core Inflation, Annual Change (%)



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Note: Core inflation is computed by excluding price-volatile and price-administered items. It also excludes the estimated direct impact of tax policy changes.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Without the direct downward impact from lower global oil prices, underlying inflation, as measured by core inflation, is projected to remain positive, averaging between 0.8 – 1.3% (Chart 2.6). This is amid subdued demand pressures and reflects the negative output gap that is expected this year. In addition, labour market conditions are expected to be weaker in 2020.

Monetary policy to be premised upon balance of risks to growth and inflation outlook

Monetary policy in 2020 will focus on providing support to domestic economic growth in the environment of subdued price pressures. Following the notable increase in risks to the growth outlook since end-2019, especially arising from the COVID-19 pandemic, the OPR was reduced in January and March 2020 by a total of 50 basis points to 2.50%. Both adjustments were intended to provide a more accommodative monetary environment to support economic growth amid low inflation.

Future monetary policy considerations will continue to be guided by the balance of risks surrounding the outlook for domestic growth and inflation, which are continuously evolving. Meanwhile, the Bank's monetary operations will continue to ensure that domestic liquidity in the financial system remains sufficient to support the orderly functioning of the domestic financial markets. As it stands, the lowering of the Statutory Reserve Requirement (SRR) ratio by 100 basis points to 2.00% in March 2020 and additional SRR flexibilities granted to Principal Dealers by recognising MGS and MGII for SRR compliance have released approximately RM30 billion worth of liquidity into the banking system.

Additional measures complement the accommodative monetary policy in ensuring continued intermediation

In the wake of the COVID-19 pandemic, Bank Negara Malaysia has implemented additional measures to ensure continued financial intermediation in support of the economy and to mitigate the economic impact of COVID-19 on households and businesses. These include providing additional funds for SMEs, amounting to a total allocation of RM13.1 billion under BNM's Fund for SMEs, together with some adjustments to the funds' features to further enhance access. In addition, an automatic 6-month moratorium on loan repayments is being implemented for individuals and SMEs to ease the financial burden of borrowers in this difficult period. Banking institutions have also been encouraged to facilitate requests by corporations to defer or restructure their loans or financing repayments in a way that will enable viable corporations to preserve jobs and swiftly resume economic activities when conditions improve[10].

Malaysian banks have the financial capacity to assist borrowers and ensure continued availability of financing to the economy, drawing on strong capital, liquidity and provisioning buffers built up over the years. At the start of the year, banks had projected sustained loan growth, reflecting their capacity and willingness to sustain credit flows to eligible borrowers. While projected loan growth is likely to be impacted by unfolding developments surrounding COVID-19, the accommodative monetary policy will reinforce support to financing activity. The OPR reductions in January and March 2020 have lowered borrowing costs for the private sector[11], while the pre-emptive boost in liquidity through the SRR ratio reduction should also provide support to banks.

[10] For details, please refer to the BNM press release dated 27 February 2020 on 'Measures to Assist Businesses and Households Affected by the COVID-19 Outbreak', and another dated 25 March 2020 on 'Measures to Assist Individuals, SMEs and Corporates Affected by COVID-19'.

[11] Following the January and March 2020 OPR reductions, all banks have further reduced their respective base rates by a cumulative 50 basis points.

Potential output and the output gap of the Malaysian economy

Potential output is the highest non-inflationary level of output that can be produced in an economy. It indicates the sustainable growth path of an economy based on prevailing factors of production and level of technology. However, due to business cycle fluctuations, actual output can differ from potential output. A negative output gap arises when actual output falls below potential output[1]. This normally indicates the presence of slack in the economy arising from weak demand and disinflationary pressures. Thus, the level of potential output and the output gap is a key economic measure which aids the Bank in carrying out its mandate of maintaining price stability for sustainable economic growth[2].

In 2019, potential output growth moderated to 4.5% (2018: 4.7%, 2011-2018 average: 5.0%). This was mainly attributable to the contraction in investment activity (-2.1%; 2018: 1.4%) as a result of softer business sentiments and the continued rationalisation efforts by the Government. This was partially offset by the marginal improvement in labour force growth in 2019 (2.1%; 2018: 2.0%).

The actual GDP growth of 4.3% in 2019 was below potential output growth. This was due mainly to weaker external demand and supply disruptions in the commodities sectors that led to an underutilisation of resources. This led to the narrowing of the positive output gap to 0.4% during the year (2018: 0.6%). As such, price pressures were benign as the inflation rate remained stable at 0.7% (Core inflation: 1.5%) during the year.

Going forward, the output gap is projected to turn negative in 2020. While potential output is expected to grow between 4.3 – 4.8%, actual output will be significantly affected by the adverse impact from the COVID-19 pandemic. Hence, actual output is projected to continue to grow at a slower pace relative to potential output in 2020.

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1 The output gap is formally defined as (Actual output level - Potential output level) / Potential output level x 100%.
2 Central Bank of Malaysia Act 2009.